Supreme Court, U.S.
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No. 02-1779

In The Supreme Court of the United States

GREG SEINFELD,

Petitioner,

vs.

CAROL A. BARTZ, JOHN T. CHAMBERS, MARY A. CIRILLO, DR. JAMES F. GIBBONS, EDWARD R. KOZEL, JAMES C. MORGAN, JOHN P. MORGRIDGE, ARUN SARIN, DONALD T. VALENTINE, STEVEN M. WEST and CISCO SYSTEMS, INC.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENTS' OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Where a public company proxy statement seeks shareholder approval of compensation proposed to be granted to the corporation's non-employee directors in the form of stock options, does Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), or Rule 14a-9 promulgated by the Securities and Exchange Commission ("SEC") thereunder, require the proxy statement to include a theoretical dollar valuation of those options?

If not, was the 1999 proxy statement issued by Cisco Systems, Inc., otherwise materially misleading because it did not include such theoretical valuations?

CORPORATE DISCLOSURE

Pursuant to Supreme Court Rule 29.6, Cisco Systems, Inc. states that it has no parent corporation and no publicly held company owns 10% or more of Cisco's stock.

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STATEMENT OF THE CASE

In 1999, the Board of Directors of Cisco Systems, Inc. ("Cisco" or the "Company"), proposed to increase the non-cash compensation to be awarded the Company's non-employee ("outside") directors beginning in fiscal 2000, by amending the Company's Automatic Option Grant Program. That proposal was detailed in the Company's proxy statement. New non-employee directors would receive initial option grants of 30,000 shares (subject to vesting requirements), rather than 20,000. With each year of continued service thereafter, non-employee directors were to receive annual grants of 15,000 shares (again, subject to vesting), rather than 10,000. As Petitioner notes (Pet. at 2-3), the options expire nine years after grant or one year after the director leaves the board, whichever occurs first. The proxy statement also disclosed the compensation paid each director for fiscal 1999: $32,000 in cash, and options to purchase 10,000 shares of Company stock.

Plaintiff sued Cisco's directors, claiming that these disclosures were materially false and misleading because Cisco did not include in the proxy statement a theoretical dollar valuation of the option compensation calculated using the Black-Scholes option pricing model. He argued that such a disclosure was required both expressly by Section 14(a) of the Exchange Act and SEC Rule 14a-9 and because certain statements in Cisco's proxy were allegedly materially misleading by virtue of its omission.

The courts below had no trouble reaching the conclusion that such a disclosure was not required by statute or rule, and that Petitioner failed to demonstrate that Cisco's proxy statement was materially misleading by omission. Accordingly, the United States District Court for the

Northern District of California dismissed Petitioner's complaint. The Ninth Circuit Court of Appeals affirmed the dismissal in a published opinion.

Petitioner's statement of the case now suggests that the underlying lawsuit has to do with accounting standards – *i.e.*, whether stock option compensation granted to corporate officers and directors should be recorded by the issuing corporations as an expense against income and, if so, in what manner. Pet. at 5.

But this lawsuit has nothing to do with those issues. Those matters (as the Petition discloses) are being debated in the pages of the *Wall Street Journal*, in the councils of the Financial Accounting Standards Board, and elsewhere. The question of whether and how option compensation should be recorded on the corporation's books is not the question presented here. The question actually presented by this case is whether estimates of the value of proposed director option grants, calculated using the Black-Scholes option pricing model, must be included in the corporation's proxy statement when the corporation seeks shareholder approval of a proposed compensation plan.

Petitioner here is asking this Court to do two things. First, he seeks to impose an obligation on companies, under Section 14(a) of the Exchange Act, to include theoretical valuations of director compensation in proxy statements – although neither the Congress nor the SEC has done so. Second, he proposes to require that those estimated valuations be derived in a particular way – by the Black-Scholes option pricing model – although each federal and state court that Petitioner's counsel has urged to do this has declined the invitation, in several instances

noting the hazard that such a use of the model could produce potentially misleading results.

REASONS FOR DENYING THE WRIT

This case presents no compelling reason for certiorari review. There is no circuit split for this Court to resolve, and no important question of federal law that this Court needs to decide. Petitioner's "question presented" – which is really one of regulatory policy, not federal law – is simply not presented by the record below.

The only question truly presented here is whether the Ninth Circuit erred in affirming dismissal of Petitioner's claim that Cisco's proxy statement was materially misleading and violated Section 14(a) of the Exchange Act or SEC Rule 14a-9 merely because it did not include Black-Scholes valuations of outside directors' option grants. The Ninth Circuit was perfectly capable of addressing this question, and did so. That Petitioner believes the Ninth Circuit's rejection of his theory was – like the decisions of all of the other courts that have ruled against his counsel – "wrong, and for a variety of bad reasons" (Pet. at 8) is no reason for this Court to grant review.

I.

THERE IS NO SPLIT OF AUTHORITY FOR THIS COURT TO RESOLVE, AND NO IMPORTANT QUESTION OF FEDERAL LAW PRESENTED BY THE DECISION BELOW

There were two basic issues presented to, and decided by, the courts below. Both are straightforward: (1) Does

Section 14(a) of the Exchange Act or SEC Rule 14a-9, require the inclusion of a theoretical dollar valuation of stock option compensation to non-employee directors? (2) If the inclusion of such theoretical dollar valuations is not affirmatively required, was Cisco's Proxy Statement otherwise materially misleading for failing to include such theoretical valuations?

The only possible general question of federal law presented is the first one, and Petitioner has done nothing to show that the lower federal courts need any help answering it. Petitioner, for example, does not contend that there is a split of authority in the lower courts. Indeed, he is compelled to admit the contrary: *i.e.*, that every court to have considered Petitioner's theory has rejected it. Pet. at 8. Two Courts of Appeals have been faced with the efforts of Petitioner's counsel to impose a Black-Scholes disclosure requirement via Section 14(a) of the Exchange Act, the Ninth and the Second. Both concluded in thorough, published opinions that the disclosure requirement urged by Petitioner does not exist. *Seinfeld v. Bartz*, 322 F.3d 693 (9th Cir. 2003); *Resnik v. Swartz*, 303 F.3d 147 (2d Cir. 2002). Their decisions are consistent with those of two federal district courts and the state courts of Delaware and New York. *See Seinfeld v. Bartz*, No. C-01-2259, 2002 WL 243597 (N.D. Cal. Feb. 8, 2002), *aff'd*, 322 F.3d 693 (9th Cir. 2003); *Resnik v. Swartz*, No. 00 Civ. 5355, 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 303 F.3d 147 (2d Cir. 2002); *Shaev v. Hampel*, No. 99 Civ. 10578, 2002 WL 31413805 (S.D.N.Y. Oct. 25, 2002); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997); *In re 3Com Corp. S'holders Litig.*, No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen v. Calloway*, 246 A.D.2d 473 (N.Y. 1998).

As the Petition obliquely discloses, Cisco is but one of several companies against which Petitioner's counsel has sought to test his theory that any proxy statement omitting Black-Scholes estimated valuations of director option compensation is materially misleading. Indeed, in suggesting that this Court's intervention is required, the Petition admits (apparently without irony) that "Only the courts have addressed this issue and only at the urging of petitioner's counsel." Pet. at 8. Yet Petitioner fails to show that the lower federal courts have failed to do their jobs, let alone in such an egregious manner that this Court need step in and get them in line.

This case simply presents no important question of federal law. None of the courts whose jurisdiction has been invoked by Petitioner (including the Ninth Circuit here) has encountered any difficulty construing the relevant statutes and regulations. None struggled to conclude that neither Section 14(a) of the Exchange Act nor SEC Rule 14a-9 requires the inclusion of Black-Scholes theoretical valuations of director option compensation in proxy statements.

Petitioner nevertheless requests the intervention of this Court because he believes these other courts were all "wrong and for a variety of bad reasons." Pet. at 8. Even if this were true, it would not constitute a basis for certiorari review of the instant Ninth Circuit opinion. *See Nat'l Labor Relations Board v. Pittsburgh S.S. Co.*, 340 U.S. 498, 503 (1951) ("This is not the place . . . to reverse a Court of Appeals because were we in its place we would find the record tilting one way rather than the other . . . .").

Nor is the far-fetched suggestion that the Black-Scholes option pricing model will not be "free of suspicion

by the public, unless this court [sic] decides that those courts are wrong" (Pet. at 11) a reason to grant review. Putting aside the fact that Petitioner's argument is based on the demonstrably false premise that the Ninth Circuit somehow disparaged the Black-Scholes model (*id.* at 1), certiorari should not be granted to endorse a particular resolution of an ongoing debate among financial professionals, companies and regulators about arcane matters of accounting and economic modeling on a record that does not even present the issue, let alone because of speculation that "the public" may view its resolution with skepticism as a result of the opinion below. *See New York v. Uplinger*, 467 U.S. 246, 249 (1984) (certiorari should not be granted where issue is not ripe, even in presence of "important constitutional issues"). That is especially true where, as here, there is a regulatory body – the SEC – charged with responsibility for determining the appropriate scope of corporate disclosures and uniquely situated to discharge that responsibility. As the Delaware Chancery Court put it, "[j]udgments concerning what disclosure, if any, of estimated present values of options should be mandated are best made . . . by an agency with finance expertise" – namely, the SEC – rather than the courts. *Lewis*, 699 A.2d at 332-33.

II.

NEITHER THE RECORD NOR THE DECISION BELOW RAISES THE QUESTION PRESENTED BY THE PETITION

The Petition really attempts to present a question of regulatory policy: whether investors who are asked to vote on outside director compensation proposals would benefit from the required inclusion of Black-Scholes theoretical

option valuations in deciding how to vote. The Petition concedes this. Pet. at 5-6.

That, however, is not a question of what existing laws or regulations *do* require, or even a question of whether the court below got those requirements wrong. It is, rather, a question of what the regulations *should* require, and that is a matter for legislators or regulators – not the courts – to address in the first instance. The lower courts have (correctly) recognized this, as the Petition acknowledges. Pet. at 10-11. Petitioner, however, asks this Court to act as the judicial rule-maker of first resort, because his counsel has been heretofore unable to persuade any lower court to invade the province of Congress and the SEC in this manner.

Even if the question presented were one of federal law, it is not an *important* one. To be "important" the issue involved must "reach to a problem beyond the academic or the episodic"; it is not enough that it be "intellectually interesting." *Rice v. Sioux City Mem'l Park Cemetery*, 349 U.S. 70, 74 (1955). Whether the Black-Scholes option pricing model can be adapted to produce reliable valuations of the options granted to non-employee directors may be a question of interest to economists, or even securities regulators considering additional disclosure requirements, but it is not an issue for this Court to decide.

III.

THE NINTH CIRCUIT DID NOT ERR

Although arguing that the lower court's decision was erroneous "is ordinarily not sufficient reason" for issuing a writ of certiorari, *Ticor Title Ins. Co. v. Brown*, 511 U.S.

117, 122 (1994), it is still significant that Petitioner is unable to demonstrate any error here. In rejecting the theory that Cisco's proxy statement was materially misleading in the absence of theoretical valuations of outside directors' options, the Ninth Circuit – like the Second Circuit and, apparently, every district court and state court to have considered the question – was guided by the plain language of the relevant statute and applicable rules and regulations.

Section 14(a) of the Exchange Act prohibits solicitation of proxies "in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a). SEC Rule 14a-9 proscribes making materially false statements in proxy materials, or "omit[ting] to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9(a). "Thus, omission of information from a proxy statement will violate these provisions if either the SEC regulations specifically require disclosure of the omitted information in a proxy statement, or the omission makes other statements in the proxy statement materially false or misleading." *Resnik*, 303 F.3d at 151.

The Ninth Circuit correctly held that Petitioner failed to identify any rule or regulation directing issuers to include theoretical valuations of outside directors' options in proxy materials, or that the omission of such estimates rendered any statement in Cisco's proxy materials false or misleading. Schedule 14A, 17 C.F.R. § 240.14a-101, and Item 402 of Regulation S-K, 17 C.F.R. § 229.402, specify the information concerning directors' options that must be included in proxy statements. Item 8 of Schedule 14A ("Compensation of Directors and Executive Officers")

states that when action is to be taken in connection with, *inter alia*, the grant of options to directors or executive officers, the proxy statement must contain the information required by Item 402. 17 C.F.R. § 240.14a-101. As both the Second and Ninth Circuits have noted, neither Schedule 14A nor any portion of Item 402 requires issuers to provide estimated valuations of options granted to outside directors. *Seinfeld*, 322 F.3d at 698; *Resnik*, 303 F.3d at 152. Indeed, while Item 402(g) spells out the information that must be furnished with respect to the compensation of directors, and requires disclosure of fees received by directors and the options proposed to be awarded to them, it makes no mention of grant-date valuation of such proposed options. *Seinfeld*, 322 F.3d at 698; *Resnik*, 303 F.3d at 152.

Moreover, Item 402(c) requires registrants to calculate "potential realizable value" (based on a set of specified assumptions) for option grants to certain *executive officers*, but imposes no similar requirement for directors.[1] Thus, inasmuch as the SEC has specifically addressed the information regarding director compensation that must be provided in proxy statements, and determined what information should be required with respect to the valuation of option grants, "'[t]he absence of any mention of option values or of valuation methods from subsection (g), Compensation of Directors, is persuasive evidence that the

[1] Significantly, even with respect to executive officers' option grants, the SEC does not require use of the Black-Scholes formula. *Seinfeld*, 322 F.3d at 698. *See also Lewis*, 699 A.2d at 332 n.9. To the extent that Petitioner suggests otherwise (Pet. at 11), he misreads Item 402(c), which permits – but does not require – use of Black-Scholes to value grants to executive officers. 17 C.F.R. § 229.402(c).

[SEC] did not intend subsection (g) to require disclosure of grant-date value calculation for the options proposed to be awarded to non-employee directors.'" *Seinfeld*, 322 F.3d at 698 (quoting *Resnik*, 303 F.3d at 152).[2]

Nor is there any basis to disturb the Ninth Circuit's determination that Petitioner failed to plead facts establishing that the absence of theoretical valuations of outside directors' option grants made any statement in Cisco's proxy materials false or misleading. Petitioner principally challenges Cisco's statement that, "Unless the market value of the Common Stock appreciates over the option term, no value will be realized from the option grants made to executive officers" (*Seinfeld*, 322 F.3d at 698), which he mischaracterizes as a representation that an "option has 'no value' . . . unless the stock price increases." Pet. at 10. First and foremost, Petitioner is unable to explain how the statement actually made by Cisco – which does not intimate that options have "no value" or opine as to their value – is a "half-truth" or otherwise inaccurate in any way. *See Resnik*, 303 F.3d at 154 (holding that a similar statement is not actionable because it "accurately describes how value is realized when options are actually exercised"); *3Com*, 1999 WL 1009210, *6-7 (statement that "[n]o gain . . . is possible

[2] Petitioner's contention that the Ninth Circuit "overlooked" Item 10 of Schedule 14A is inaccurate. There is no mention in Item 10 of Black-Scholes or any other option pricing model, much less a directive that companies use such models to provide estimated valuations of option grants to directors. 17 C.F.R. § 240.14a-101. Accordingly, far from supporting Petitioner's position, Item 10 actually provides further confirmation that the SEC has deliberately elected not to require registrants to include such estimates in proxy statements.

without an increase in stock price" is "true on its face, even standing alone").

Nonetheless, Petitioner asserts that the challenged statement is misleading in the absence of estimated valuations, because Financial Accounting Standards Board ("FASB") Statement No. 123 purportedly approves of the use of the Black-Scholes pricing model. *See Seinfeld*, 322 F.3d at 698; Pet. at 10. However, FASB No. 123 concerns year-end financial statements and does not purport to address the requirements for proxy statements, and therefore "is not relevant to the issue presented here." *Seinfeld*, 322 F.3d at 698. *See also Resnik*, 303 F.3d at 153; *Lewis*, 699 A.2d at 332-33. While Petitioner ostensibly disputes this conclusion (Pet. at 12), he tellingly fails to cite any case, rule, regulation, commentator or other authority suggesting that FASB No. 123 has any application to proxy materials or the information required to be included therein. In any event, as the Ninth Circuit explained, the challenged statement relates solely to options granted to executive officers, and is "completely unrelated to the amendments to the plan [Petitioner] is challenging, which concerned options proposed to be granted to outside directors." *Seinfeld*, 322 F.3d at 698. *See also Resnik*, 303 F.3d at 154 (statement concerning executive officers' options "does not purport to make any representations

about the options proposed to be granted to the non-employee directors under the Plan").[3]

CONCLUSION

This Court should not occupy its time with administrative rule-making – especially when there exists a responsible administrative agency, with financial expertise, charged by Congress with this duty. The Ninth and

[3] Furthermore, although the Ninth Circuit had no need to reach the issue, there was another independent basis for affirming dismissal of Petitioner's claims: he failed to demonstrate that Black-Scholes estimates of the value of outside directors' option grants were material. Black-Scholes is a formula designed to provide estimated valuations of publicly traded options. *Cramer v. C.I.R.*, 101 T.C. 225, 241 (1993), *aff'd*, 64 F.3d 1406 (9th Cir. 1995); *Lewis*, 699 A.2d at 331-32. By contrast, the options granted to Cisco's outside directors were not publicly traded or transferable, and were subject to vesting and other restrictions. Where options are subject to vesting and are granted to outside directors, whose service may cease at any time, it is not reasonably possible to determine an option's term (one of the key variables in the Black-Scholes model). *Lewis*, 699 A.3d at 331 n.8. As a result, the "model overstates the value of options that can be exercised at any time during their term." *Id.* at 331-32. Notably, while Petitioner asserts (without explanation) that such distortion is "'significantly overstate[d]'" (Pet. at 9), he does not dispute its existence. Moreover, option valuation models (including Black-Scholes) depend on subjective estimates of such factors as volatility. *Cramer*, 101 T.C. at 241. Accordingly, such models can produce a range of theoretical valuations – any of which could be challenged as speculative or even misleading, which is precisely what Petitioner's counsel has done in at least one other case. *See Shaev*, 2002 WL 31413805, at *6. Consequently, estimated valuations of the Cisco directors' option grants would not be viewed by the reasonable shareholder as "important in deciding how to vote," or "significantly alter[ing] the 'total mix' of information made available." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Second Circuits both noted this in declining the invitations of Petitioner's counsel to do the work of the SEC. *Seinfeld*, 322 F.3d at 700; *Resnik*, 303 F.3d at 154-55.

There is no reason presented by the Petition to believe that Congress (which only recently passed a number of new disclosure requirements in the form of the Sarbanes-Oxley Act) or the SEC (which has been busily implementing these requirements with new rules) could not impose the disclosure requirement sought by Petitioner if indeed either of them concluded that this would benefit shareholders. *See Rice*, 349 U.S. at 77 ("in the absence of compelling reason, we should not risk inconclusive and divisive disposition of a case when time may further illumine or completely outmode the issues in dispute"). That they have not is no reason for this Court to assume the role of legislators or regulators.

The petition for writ of certiorari should be denied.

Respectfully submitted,

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